COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

At Richmond, SEPTEMBER 15, 1999

APPLICATION OF

ROANOKE GAS COMPANY CASE NO. PUE980626

For general increase in rates and
to revise its tariff.

FINAL ORDER

On September 30, 1998, Roanoke Gas Company ("Roanoke" or the "Company") filed an application requesting additional operating revenues of $877,527, based on a test year ending June 30, 1998, and a return on equity of 10.7%. The Company stated that the rate increase was needed to cover the costs of its safety and service obligations, and to recover the capital costs related to replacing its aging distribution system. Roanoke requested that its proposed rates and charges, and proposed revisions to its tariff, become effective for service rendered on and after October 30, 1998.

By Order issued October 27, 1998, the Commission suspended the proposed rates, charges and tariff revisions for 150 days from the date of the filing, thus permitting the rates to take effect for service rendered on and after February 27, 1999, subject to refund with interest. The Order also scheduled a public hearing for April 13, 1999; established a procedural schedule for the filing of pleadings, testimony and exhibits; and appointed a hearing examiner to conduct all further proceedings.[1]

[1] By Order dated February 25, 1999, the Commission consolidated a disputed accounting issue that was under consideration in another Roanoke proceeding, Case No. PUE970908, with the captioned matter.

On January 25, 1999, Roanoke filed additional direct testimony in which it lowered its revenue request to $722,565. Rates based on the lowered request were to be effective on February 27, 1999, subject to refund with interest.[2]

On March 19, 1999, Staff, the Company, and the Office of the Attorney General, Division of Consumer Counsel ("AG") filed a written Stipulation, and on April 5, 1999, a Supplemental and Amending Stipulation (collectively, "Stipulation").[3] The Stipulation sets forth the parties' agreement that resolved all but one of the issues in this case. The parties agreed to a rate increase designed to recover an additional $433,650 in gross annual revenues. The one disputed issue is discussed below.

On April 7, 1999, the Company filed a Motion to Implement Rates and Provide Refund ("April 7 Motion"). In this Motion, Roanoke requested authority to implement the rates contained in the Revised Exhibit 2 attached to the Supplemental and Amending Stipulation, and to refund, with interest, any monies collected in excess of the interim rates since it placed these rates into effect on February 28, 1999**.**

On April 8, 1999, the Hearing Examiner entered a Ruling granting the April 7 Motion, subject to any refunds that may be required when the Commission determines the final rates in this case.

Background

The sole issue in controversy at the time of the hearing was whether the Distribution System Renewal Surcharge ("DSR Surcharge"), which the Company proposed in connection with its distribution system renewal program ("DSR Program"), should be approved by the Commission. Roanoke implemented the DSR Program in 1993, to replace the bare steel and cast iron sections of the Company's distribution system over a span of 25 years. These sections of the

[2] On February 5, 1999, Roanoke advised the Commission that it would place the interim rates into effect on February 28, 1999.

[3] A copy of the Stipulation is attached to the Hearing Examiner's Report as Appendix A. The provisions of the Stipulation also are set forth in the Hearing Examiner's Report at pages 2-5.

distribution system are generally the oldest and most prone to failure. According to Roanoke, the goal of the DSR Program is to protect the public and to ensure compliance with federal and state pipeline safety regulations.

Roanoke has proposed the DSR Surcharge to permit the recovery of the carrying costs and depreciation on prudently incurred distribution system renewal investment outside the scope of a full rate case proceeding. Under Roanoke's proposed schedule, the Company would annually file with the Commission its distribution system renewal investment and proposed DSR Surcharge for administrative review and approval. According to the Company, this streamlined process would encourage the ongoing efforts to improve system safety and reliability, while reducing the administrative and legal costs of frequent rate case filings.

The Hearing and Hearing Examiner's Report

On April 13, 1999, this matter came to be heard by Hearing Examiner Michael D. Thomas. Counsel appearing at the hearing were Michael J. Quinan, Esquire, counsel for Roanoke; John F. Dudley, Esquire, counsel for the Attorney General's Office; and Don R. Mueller, Esquire, and C. Meade Browder, Jr., Esquire, counsel for Commission Staff. No public witnesses appeared at the hearing to testify.

On June 29, 1999, the Hearing Examiner issued his Report ("Hearing Examiner's Report"). He found that this case presents three issues for the Commission's consideration, specifically: (1) whether the rates, stipulated to by the parties, are reasonable; (2) whether a voluntary rate design experiment, such as the DSR Surcharge, is permitted under Virginia law; and, (3) whether the Commission should approve or disapprove the surcharge.

With respect to the rates set forth in the Stipulation, the Examiner observed that the accounting and cost of capital adjustments agreed to by the parties effectively reduced the Company's rate request by 50 percent. The Examiner found that the stipulated rates are fair, reasonable, and not unfairly discriminatory.

Turning to the DSR Surcharge, the Hearing Examiner agreed with Staff that the surcharge does not meet the criteria for an automatic adjustment clause as set forth by the

Commission in *Application of Old Dominion Power Company, Inc*.[4] He also found that there is no doubt that the Company's aging distribution system must be replaced for the system to comply with state and federal gas pipeline safety requirements. The Examiner further found that the DSR Surcharge is in the public interest because it encourages Roanoke to continue its ongoing DSR Program which improves the overall safety and reliability of the Company's gas distribution system. The Examiner stated that the real question is whether the efficiencies expected from the surcharge actually will be achieved.[5] According to the Examiner, this question could be answered only after collecting and analyzing in-depth data gained during the three-year experimental period. The Examiner therefore concluded that there is a need to proceed with the DSR Surcharge as a voluntary rate design experiment pursuant to § 56-234 of the Code of Virginia to find out whether, in fact, the anticipated benefits would materialize.

The Examiner characterized the proposed surcharge as "an innovative solution" to recover the prudently incurred costs of replacing the non-revenue generating distribution system. The Examiner commended the Company for its willingness "to try something new and different because it believes that it is the right thing to do for the Company and the customers."[6] In addition, the Examiner noted that Staff and the AG neither supported, nor opposed, the proposed surcharge. Both, however, recommended that certain safeguards be required and expressed several concerns in their post-hearing briefs. The Examiner addressed several of these concerns and other points in the post-hearing briefs that, in his view, warranted further discussion.

No comments on the Hearing Examiner's Report were filed.

NOW THE COMMISSION, upon consideration of the record and the Hearing Examiner's Report, as well as the applicable statutes, is of the opinion and finds that the Hearing

---

[4] Case No. PUE830035, 1984 S.C.C. Ann. Rept. 408, 409 ("*Old Dominion*").

[5] Hearing Examiner's Report at 12.

[6] *Id.*

Examiner's findings and recommendations should be adopted, subject to the modifications discussed below.

In its post-hearing brief, Staff stated that it continues to be concerned that the proposed surcharge may: (i) ignore offsetting savings in other areas; (ii) ignore earnings generated by new growth; (iii) diminish the Company's incentive for efficient management and hard bargaining in negotiating construction contracts; and, (iv) not provide an opportunity for hearing or public scrutiny of the costs recovered through the surcharge. In its post-hearing brief, the AG expressed concern that the DSR Surcharge: (i) would result in diminished opportunity for public review and comment prior to rate increases; (ii) may lead to overrecovery of reasonably incurred costs; and, (iii) may be inequitable to smaller customers.

We find that the proposed Stipulation, as well as additional testimony proffered by Company and Staff witnesses at the hearing, sufficiently address Staff's and the AG's concerns. Under the terms of the Stipulation, the DSR Surcharge will be limited to an initial three-year period expiring on November 30, 2002. Collections through the DSR Surcharge shall be limited to those based on a maximum annual investment of $1,500,000 in the distribution renewal program. The Company will be required to file earnings tests for each fiscal year ending September 2000 through September 2002, which will enable Staff to determine whether the Company has overearned. Surcharge collections, including interest,[7] will be refundable to the extent the Company's cumulative earnings exceed its return on equity benchmark over the three-year surcharge period. The benchmark for determining overearnings will be 10.25%, which is below the authorized midpoint of the return on equity range. Significantly, the Company agreed

[7] The Stipulation does not specify how interest would be calculated for refunds on any surcharge overcollections. We will address the issue of how the interest on any such refunds should be calculated if, and when, such refunds are required.

to a moratorium on filing a rate case for new non-gas rates throughout the three-year surcharge period.[8]

We find that the safeguards described above adequately address any concerns of potential overearnings; further, the safeguards should give the Company an increased incentive to hold down costs and look for ways to increase operating efficiencies wherever possible. Moreover, we agree with the Hearing Examiner that this surcharge mechanism will encourage Roanoke to continue its renewal program to improve the overall safety and reliability of its gas distribution system.

We shall require Roanoke to submit to Staff annual DSR Surcharge filings supporting the development of its proposed annual surcharges. These filings shall be made no later than 45 days prior to the effective dates of the three annual surcharge periods, and shall be made available for public inspection. In the event Company, Staff or other interested parties are unable to reach agreement regarding the amount of the surcharge during this 45-day period, the Commission's Rules of Practice and Procedure permit an informal resolution of any disputes. If the informal dispute procedure does not resolve the issues in controversy, then the Staff or parties may apply to the Commission for relief, and, consistent with Roanoke's representation, the Company's proposed annual DSR Surcharge for the surcharge period shall not become effective until the Commission makes its final determination of the issues in controversy.

Further, we will require the Company to report annually to the Staff information pertaining to the ongoing distribution system renewal operation, including: (i) the data from Roanoke's leak detection surveys and other operational inputs considered in planning system replacements; (ii) the exact amount of mains and service connections replaced during the year; and, (iii) the amount of main replacement that is revenue producing, if any, and not recoverable by the surcharge. We also will hold the Company to its commitment to allow Staff access to the

[8] The Stipulation provides for an exception to the moratorium, when "circumstances make it necessary for the protection of the legitimate interests of the Company's customers or its shareholders." Stipulation, paragraph 7, subparagraph f.

internal analysis it performs in the evaluation of contractor bids for distribution system renewal projects. We believe that this information will be sufficient to allow the Staff to review adequately the system renewal costs and to determine the proper annual surcharge. In view of the foregoing, we find that the DSR Surcharge is reasonable, and we hereby approve the proposed surcharge as an automatic rate adjustment clause to be effective for a three-year period.[9] Although not an experiment, the DSR Surcharge will operate for three years. If the Company wishes to continue or modify this Surcharge, it must apply to the Commission to do so. If the Company does not apply to continue the Surcharge, it will expire on November 30, 2002.

In the past, we have approved automatic adjustment clauses in limited circumstances, generally, in the case of wholesale power cost adjustment clauses for electric cooperatives and purchased gas adjustment clauses for gas companies. In *Old Dominion, supra*, we rejected a proposal made by Old Dominion Power Company, Inc. ("Old Dominion") to implement a purchase power expense clause that would automatically flow through to its customers any and all increased costs of purchasing power (at wholesale rates that are regulated by the Federal Energy Regulatory Commission) from its parent company, Kentucky Utilities Company. The Commission explained that the purpose of an automatic adjustment clause is to allow a company to adjust, without a formal rate proceeding, its revenues in response to changes in the cost of a relatively volatile, major expense item over which the company has little control. The Commission rejected Old Dominion's request, stating that a wholesale purchased power clause in the circumstances of that case would be inappropriate because purchased power had not been shown to be a volatile expense and Old Dominion would be able to exert considerable control over its purchased power costs since its officers were also officers of its parent company.[10]

We find this situation to be significantly different from that at issue in *Old Dominion.* Because the Company will be subject to an earnings test, using a benchmark below the

[9] We do not find the DSR Surcharge proposal to be an experiment under §56-234 of the Code of Virginia.

[10] *See Old Dominion*, 1984 S.C.C. Ann. Rept. at 409.

authorized midpoint of the return on equity range, for each of the three years that the DSR Surcharge is collected, along with the other safeguards discussed above, the Company will not have an opportunity to overearn. Moreover, Roanoke has agreed that it will not file for a non-gas rate increase during the three-year surcharge period, except under the limited circumstances set forth in the Stipulation. Based on these factors, and taking into account the size of the Company, the safety considerations present, and the inherent safeguards of the proposed surcharge and the reporting requirements, we conclude that the DSR Surcharge should be approved as an automatic adjustment clause.

We also find that the Company's proposed allocation of the DSR Surcharge is reasonable. The proposed rate design allocates the DSR Surcharge among Roanoke's residential and commercial customer classes, with no increase to interruptible industrial customers. Since the Company's distribution system renewal plan over the next few years focuses primarily on main replacements in older residential neighborhoods with some small commercial businesses, the surcharge will be allocated primarily to customers receiving the benefits of the program.

Moreover, the proposed allocation is consistent with a class cost of service study performed by the Company that indicates interruptible customers already are providing a return in excess of other classes. Concerns about the customers' reaction to the surcharge should be assuaged by the Company's stated intent to include a notice on customers' bills concerning the DSR Surcharge, and to respond promptly to customer inquiries once the surcharge is implemented. It is our opinion that such notice and the Company's availability to address customer questions and concerns are essential.

Finally, we wish to commend Roanoke Gas, the Commission's Staff and the AG for developing a Stipulation that has resolved a substantial number of complex issues in this general rate case. We also commend Roanoke Gas for proposing the DSR Surcharge. As approved here, the DSR Surcharge will provide an innovative approach to cost recovery, allowing for the continued improvement of the safety and reliability of Roanoke's gas distribution system and including adequate safeguards that will protect the interest of customers.

Accordingly, IT IS ORDERED THAT:

(1) The findings and recommendations of the Hearing Examiner's June 29, 1999 Report, as modified and supplemented herein, are accepted.

(2) The Company shall be granted an increase in gross annual revenues of $433,650, effective for service rendered on and after February 28, 1999.

(3) The Company shall forthwith file revised permanent schedules of rates and charges designed to produce the additional revenues found reasonable herein, effective for service rendered on and after February 28, 1999. The final increase in revenues shall be recovered through the rates filed as part of the Supplemental and Amending Stipulation, attached to the June 29, 1999 Report of the Hearing Examiner. In addition, the Company shall file appropriate tariff pages addressing its DSR Surcharge, including the charge and its calculation for each applicable surcharge period as that surcharge period occurs.

(4) On or before October 1, 1999, Roanoke is directed to recalculate, using the rates being established by this order, each bill it rendered that used, in whole or in part, the interim rates being replaced by the rates established by this Order. In each instance where application of the rates being established by this Order yields a reduced bill to the customer, the Company is directed to refund with interest as directed below, the difference.

(5) Interest upon the ordered refunds shall be computed from the date payment of each monthly bill was due during the interim period until the date refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's Selected Interest Rates ("Selected Interest Rates") (Statistical Release G.13), for the three months of the preceding calendar quarter.

(6) The interest required to be paid herein shall be compounded quarterly.

(7) The refunds ordered in Paragraph (4) above may be accomplished by credit to the appropriate customer's account for current customers (each refund category shown separately on

each customer's bill). Refunds to former customers shall be made by check to the last known address of such customers when the refund amount is $1 or more. Roanoke may offset the credit or refund to the extent no dispute exists regarding the outstanding balances of its current customers or customers who are no longer on its system. To the extent that outstanding balances of such customers are disputed, no offset shall be permitted for the disputed portion. The Company may retain refunds owed to former customers when such refund amount is less than $1. However, Roanoke shall prepare and maintain a list detailing each of the former accounts for which refunds are less than $1, and in the event such former customers contact the Company and request refunds, such refunds shall be made promptly. All unclaimed refunds shall be handled in accordance with § 55-210.6:2 of the Code of Virginia.

(8) On or before October 15, 1999, the Company shall file with the Division of Energy Regulation a document showing that all refunds have been lawfully made pursuant to this order, and itemizing the costs of the refund and accounts charged. Such itemization of costs shall include, inter alia, computer costs, the personnel hours, associated salaries, and costs for verifying and correcting the refunds directed in this Order.

(9) The DSR Surcharge is approved as an automatic adjustment clause through November 30, 2002. If the Company desires to continue or modify this surcharge, it must seek further authority to do so from the Commission.

(10) There being nothing further to be done herein, this matter is hereby dismissed from the Commission's docket of active proceedings.